Supreme Court, U.S.
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No.

In The

Supreme Court of the United States

DELUXE CORPORATION,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

On Petition For A Writ Of Certiorari To The Court Of Appeal Of California For The First Appellate District

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Public Law 86-272 deprives a State of the power to tax the income of a corporation engaged in business in that State where that corporation's only activity in the State is the solicitation of orders. The general rule in California is that the California income of a unitary group of corporations is assigned to each of the corporations, and taxed, based on each corporation's California activities. Nevertheless, where a corporation is immune from California taxation under Public Law 86-272, as in this case, California's taxing authorities employ a procedure that shifts the income earned by that corporation to the remaining taxable corporations of that group and then impose the franchise tax upon that shifted income. The question presented is the following:

Whether California's shifting income procedure "evades the purpose of [Public Law 86-272]," *Heublein, Inc. v. South Carolina Tax Commission*, 409 U.S. 275, 279 (1972), and violates federal prohibitions against state taxation of a corporation's income if its sole in-state activity is the solicitation of orders.

LIST OF PARTIES

The parties are as stated in the caption.

RULE 29.6 STATEMENT

Deluxe Corporation does not have a parent company, nor does any other publicly held company own 10% or more of Deluxe Corporation's stock.

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PETITION FOR A WRIT OF CERTIORARI

Deluxe Corporation respectfully petitions for a writ of certiorari to review the judgment of the Court of Appeal of the State of California, First Appellate District, Division Two, in this case.

OPINIONS BELOW

The Opinion of the Court of Appeal (App. 1a) is not officially reported. The judgment and statement of the Superior Court of California, City and County of San Francisco (App. 13a), is not officially reported. The California Supreme Court's denial of Deluxe Corporation's petition for review (App. 37a) is not officially reported.

JURISDICTION

The judgment of the Court of Appeal was entered on April 26, 2001. (App. 1a.) The Supreme Court of California denied Deluxe Corporation's petition for review on July 11, 2001. (App. 37a.) The jurisdiction of this Court rests on 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Public Law 86-272, 15 U.S.C. § 381, provides in relevant part:

§ 381. Imposition of net income tax.

(a) Minimum standards. No state or political subdivision thereof, shall have power to impose, for any taxable year ending after [September 14, 1959], a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

(1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and

(2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

. . . .

The Supremacy Clause of the United States Constitution, U.S. Const. art. VI, cl. 2, provides, in relevant part: "This Constitution, and the laws of the United States which shall be made in pursuance thereof . . . shall be the supreme law of the land; and the judges in every state shall be bound thereby, any thing in the Constitution or laws of any state to the contrary notwithstanding."

The Commerce Clause of the United States Constitution, U.S. Const. art. I, § 8, cl. 3, provides, in relevant part:

"The Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

STATEMENT

When determining the California income of affiliated corporations engaged in a unitary business, California first uses formula apportionment to arrive at the group's California income. Next, California's general rule is to assign (and tax) that income to the individual corporations pro rata based on each corporation's California activities. However, where one or more of those corporations are immune from California tax under Public Law 86-272, California abandons this general rule and instead assigns the group's income only to the corporations that it can legally tax. It does this despite the fact, as in this case, that such income is apportioned to California based on the in-state, but nontaxable, activities of corporations protected by Public Law 86-272. As a consequence, California taxes the portion of the unitary group's income that is protected by Public Law 86-272. The State's position and the lower court's decision rest on the premise that, under the guise of apportionment of income of a unitary group, a State may tax the income otherwise protected by Public Law 86-272 or the Constitution.

A. Deluxe's Business

During the years in issue, Petitioner Deluxe Corporation ("Deluxe") manufactured and sold checks and business forms to businesses throughout the United States,

including California. Deluxe also operated manufacturing plants in California. There is no dispute that Deluxe was subject to California's income tax during the years in issue.

In addition, Deluxe engaged in a unitary business with two wholly-owned subsidiaries, Current, Inc. ("Current") and Colwell Systems, Inc. ("Colwell"). Current sold greeting cards, gift wrap, checks, and related items on a mail-order basis, and Colwell sold business forms also on a mail-order basis.

Current's principal place of business and all its employees and property were located in Colorado. Colwell's principal place of business and all its employees and property were located in Illinois. Current and Colwell each sent catalogs describing their products to California customers. Orders for Current's and Colwell's products were transmitted by fax, telephone, or mail to each company's offices located outside California, and all orders were filled by shipment from outside California. No other person or entity performed any activities in California on behalf of Current or Colwell. Although both Current and Colwell made sales to California customers, neither company was subject to the State's income tax. Public Law 86-272 precluded California from taxing the income of Current and Colwell. (Joint Stipulation of Facts ("JS") ¶ 18 and ¶ 22.)

B. California's Taxing Scheme and Assessment

California imposes a franchise tax measured by net income on corporations for the privilege of doing business in California. Cal. Rev. & Tax. Code §§ 23151,

23151.1. California employs a four-step process to determine the tax payable by corporate members of a unitary group: first, it determines the composition of the unitary group; second, it calculates the group's business income attributable to California; third, it determines the amount of the group's California income (by use of the three-factor formula); and fourth, it assigns the group's California income to each corporation so that it can be offset by losses and credits, and then if taxable, taxed.

In calculating the California taxable income of Deluxe, Respondent Franchise Tax Board ("FTB") first determined that Deluxe, Current, and Colwell were engaged in a unitary business. Deluxe agrees with this determination. Second, the FTB determined the unitary group's "pot" of business income subject to apportionment. There is no dispute that this amount was correctly determined, and that it properly included Current's and Colwell's business income.

Third, the FTB computed the unitary group's California income by formula apportionment. During the years in issue, the apportionment formula was the simple average of three fractions (also referred to as "factors"): the unitary group's in-state property over total property (the "property factor"), its in-state payroll over total payroll (the "payroll factor"), and its in-state sales over its total sales (the "sales factor"). Cal. Rev. & Tax. Code § 25128. Although neither Current nor Colwell was taxable by California, their California factors were included in the numerator of the formula. Deluxe agrees that the California apportionment percentage and the resulting California income accurately reflect the unitary group's activities in California.

Fourth, the FTB assigned the California income to the individual corporations. This assignment is necessary because the California franchise tax is imposed on individual corporations and not on the unitary group. *See, e.g., Edison Cal. Stores, Inc. v. McColgan*, 30 Cal. 2d 472, 183 P.2d 16 (1947). The dispute in this case centers on the proper assignment of the unitary group's California income.

In general, the FTB's rule is to assign the California income based on the relative weight of each corporation's California activities. *See* Cal. Franchise Tax Bd., Legal Ruling No. 234 (Oct. 27, 1959) (reproduced at App. 47a). For example, if two corporations each account for 50 percent of a unitary group's California sales, payroll, and property, the group's California income apportioned to California would be assigned to each corporation on a 50-50 basis. However, if the general rule results in the assignment of income to a corporation that California cannot tax (for example, because of Public Law 86-272), the FTB abandons the general rule in favor of an arbitrary rule that assigns the immune California income *solely* to those corporations that are taxable – thereby shifting income from nontaxable corporations to taxable corporations. *See* Cal. Franchise Tax Bd., Notice No. 90-3 (June 8, 1990) (reproduced at App. 42a.)[1] Thus, in the previous

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[1] California recently promulgated a new rule that attempts to partially relieve the defect in California's method of assigning income on a going-forward basis. Cal. Code Regs. tit. 18, § 25106.5(c)(7)(B). However, the new administrative rule does not cure the defect where a taxpayer has California employees and/or property and is immune from tax in California. As a result, California's current practice continues to

example, if one corporation were immune from taxation by California, the group's California income would be assigned entirely to the remaining taxable corporation, even though the tax-immune corporation's factors provide the predicate for the apportionment of that income to California.

This shifting of income is explicitly illustrated by the examples contained in the FTB's Legal Ruling No. 234 (Oct. 27, 1959) and Notice No. 90-3 (June 8, 1990). (App. 47a and App. 42a, respectively.) The example set forth in Legal Ruling No. 234 establishes California's general rule: a unitary group's California income is assigned to each corporation, based on each corporation's relative California factors, *i.e.*, on a pro rata basis. Thereafter, each corporation reports its assigned income, offset by any separate losses, tax credits, etc., to determine whether any California tax is owed with respect to its assigned income. The example in Notice No. 90-3 describes an exception to the general rule. If, as in this case, one or

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circumvent the protection of Public Law 86-272. In addition, the decision of the lower court upholds California's tax scheme for all tax years ending prior to the change and leaves open the option for California to revert to the former rule. Furthermore, we are aware of four other States (Arizona, Indiana, Kansas, and Utah) that currently follow the rule employed by California during the years at issue. *See Airborne Navigation Corp. v. Ariz. Dep't of Rev.*, No. 395-85-I, 1987 Ariz. Tax LEXIS 34 (Feb. 5, 1987); Ind. Dep't of Rev., Informational Bulletin No. 12, 1988 Ind. Tax LEXIS 27, June 1988, *revised* Nov. 1993; Ind. Dep't of Rev., Tax Policy Directive No. 6, Ind. St. Tax Rptr. (CCH) ¶ 89-956, June 1, 1992; Kan. Dep't of Rev., Kan. Rev. Rul. 12-91-1, Kan. St. Tax Rptr. (CCH) ¶ 18-735, Feb. 1, 1991; and Utah Admin. Code 865-6F-24.

more of the corporations of the unitary group are immune from taxation, the income attributable to the nontaxable corporation under the general rule is assigned only to the corporations subject to tax. Thus, income that would have been assigned to a nontaxable corporation under the general rule, is instead shifted under the special rule to a corporation that California can tax. This income shift is made not because the income is not properly attributable to the nontaxable corporation, but *solely* because California cannot tax that corporation.

In this case, because Current and Colwell were immune from California tax under Public Law 86-272, California abandoned its general rule for assigning the group's California income and instead assigned, and taxed, all of that income (including that of Current and Colwell) to Deluxe, the only taxable member of the unitary group. Thus, the FTB increased Deluxe's income by $1,708,578 for 1988 and by $1,803,226 for 1989. (Supplemental Joint Stipulation of Fact, ¶ 32 and ¶ 35.) This resulted in tax deficiencies of $158,898 for 1988 and $167,700 for 1989. (*Id.*)

C. The Proceedings Below

In November 1997, Petitioner filed a suit for a refund of taxes and interest in the Superior Court, City and County of San Francisco. Petitioner alleged, among other things, that the FTB's method of computing Deluxe's California taxable income violated Public Law 86-272 and was preempted by federal law, including the United States Constitution.

(a) The Superior Court.

In May 1999, the Superior Court upheld the FTB's mechanism for assigning the California income of a unitary group to Deluxe. The court conceded that, "Deluxe provides numerous examples which accurately reflect how Deluxe is paying taxes on income generated in California by Current and Colwell." (App. 21a.) Nevertheless, the court concluded that the unitary business principle and formula apportionment, in effect, trump Public Law 86-272.

Upholding the tax upon the income attributable to Current and Colwell, the Superior Court relied principally upon the notion that the amount of a unitary business's income taxed by a State should not vary depending on whether the unitary business is conducted through separate divisions within a single corporation or separate corporations. Thus, the court concluded:

> Bearing in mind the purpose of treating members of a unitary group in the same manner regardless of the form of their organization, it is consistent to include the income of all members for purposes of apportionment and to divide the tax liability among only those members within the state's taxing jurisdiction. Clearly, Deluxe would be responsible for the tax burden of Current and Colwell if they were simply divisions of the Deluxe [C]orporation, rather than individually incorporated subsidiaries. Accordingly, the principles of combined reporting may reasonably be considered to demand similar treatment.

(App. 25a-26a.)

(b) The Court of Appeal.

In April 2001, the California Court of Appeal affirmed the decision of the Superior Court. Like the trial court, the Court of Appeal relied principally upon the theory that the unitary business doctrine and formula apportionment trump Public Law 86-272. (*See* App. 9a.) The Court of Appeal viewed the central issue as the proper apportionment of the unitary group's income to California. In the court's view, so long as the income apportioned to California reflects the income "attributable to California generated by the members of Deluxe's unitary group" (*id.*), California may tax that income without regard to Public Law 86-272.

(c) The California Supreme Court.

On July 11, 2001, the California Supreme Court denied Deluxe's petition for review. (App. 37a.)

REASONS FOR GRANTING THIS PETITION

The decision of the California Court of Appeal warrants review by this Court for two compelling reasons. First, in *Heublein, Inc. v. South Carolina Tax Commission*, 409 U.S. 275, 279 (1972), this Court warned that if it were persuaded the State had evaded the intent of Public Law 86-272, "we would, of course, be reluctant to uphold its actions." This is just such a case. The tax scheme challenged here was applied by California *solely* because Current and Colwell were immune from taxation under Public Law 86-272. California treated the immune corporations as if they earned zero income in California and

instead shifted all of Current's and Colwell's California income to Deluxe. Indeed, as noted above, the trial court expressly confirmed that "Deluxe is paying taxes on income generated in California by Current and Colwell." (App. 21a.) This scheme is irreconcilable with the controlling federal law, which prohibits California from taxing the California income of Current and Colwell, and decisions of this Court, which provide that a State may not indirectly tax that which it cannot tax directly.

Second, review is necessary to resolve an important question involving Public Law 86-272, which one leading state tax scholar has described as "[t]he most important piece of legislation Congress has enacted limiting the states' power to tax interstate business. . . . " 1 J. Hellerstein & W. Hellerstein, State Taxation ("Hellerstein"), ¶ 6.16, pp. 6-46 (3d ed. 2001). The States are divided as to whether a State must abide by Public Law 86-272 in the context of affiliated corporations engaged in a unitary business.[2] Moreover, if allowed to stand, the Court of Appeal's decision would open a gaping hole in Public

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[2] *Compare Airborne Navigation*, 1987 Ariz. Tax LEXIS 34 (following California's position); Ind. Dep't of Rev., Tax Policy Directive No. 6 (to the same effect); Kan. Dep't of Rev., Rev. Rul. 12-91-1 (to the same effect); *and* Utah Admin. Code 865-6F-24 (to the same effect); *with Great N. Nekoosa Corp. v. State Tax Assessor*, 675 A.2d 963 (Me. 1996) (rejecting California's position in a similar context); *Dover Corp. v. Dep't of Rev.*, 648 N.E.2d 1089 (Ill. App. 1995) (to the same effect); *and* Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States Under Public Law 86-272 (2d rev. July 29, 1994) (indicating that the following States have rejected California's position: Arkansas, Colorado, Hawaii, Idaho, Louisiana, Montana, New Jersey, New Mexico, North Dakota, Oregon, and Rhode Island).

Law 86-272 and the constitutional structure that protects state taxpayers from illegal exactions. If Respondent is right, and the limitation of Public Law 86-272 can be circumvented merely by shifting immune income among members of a unitary group from nontaxable corporations to taxable corporations, even when such income is clearly earned by the nontaxable corporation, then the protection of Public Law 86-272 is illusory. Moreover, if the decision below is left undisturbed, it will pave the way for the States to avoid federal limitations on the States' taxing powers by doing indirectly that which they cannot do directly.

I. THE DECISION BELOW CONFLICTS WITH FEDERAL LAW AND SETTLED DECISIONS OF THIS COURT THAT A STATE MAY NOT DIRECTLY OR INDIRECTLY TAX INCOME OF A CORPORATION WHOSE ONLY ACTIVITY IN THE STATE IS THE SOLICITATION OF ORDERS FOR TANGIBLE PERSONAL PROPERTY

The practical effect of the FTB's position and the lower court's decision is to tax income that is exempt from taxation under Public Law 86-272. This conclusion follows from three essentially undisputed propositions. First, the parties have stipulated that California could not tax the California income of Current or Colwell because those corporations were protected by Public Law 86-272. (JS ¶ 18 and ¶ 22.) Second, as the trial court determined, "Deluxe [paid] taxes on income generated in California by Current and Colwell." (App. 21a.) Third, solely because of the nontaxable status of Current and Colwell,

all of the unitary group's California-source income, including that earned by Current and Colwell, was assigned entirely to Deluxe and taxed by California.

As noted above, the California Court of Appeal viewed the essential dispute in this case as the proper apportionment of the unitary group's income to California, even though Petitioner never disputed that the amount of income apportioned to California was proper. Relying principally on *Citicorp North America, Inc. v. Franchise Tax Board*, 83 Cal. App. 4th 1403, 1415, 100 Cal. Rptr. 2d 509 (2000), *cert. denied*, ___ U.S. ___, 121 S. Ct. 2623 (2001), the court determined that so long as the income apportioned to California reflects the income "attributable to California generated by the members of Deluxe's unitary group" (App. 9a), California may tax that income without regard to Public Law 86-272.[3] The court was unconcerned with the obvious fact that the California income earned by Current's and Colwell's California sales was protected by Public Law 86-272. In short, simply because the State sent the tax bill to Deluxe, and not Current and Colwell, the State did not, in the court's view, impermissibly tax the income of those immune corporations. Such a rule, however, flies in the face of Public Law 86-272 and the Constitution.

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[3] The Court of Appeal's reliance on *Citicorp*, however, is misplaced. The *Citicorp* decision is inapposite in this case since that case did not involve the violation of Public Law 86-272 raised here, and the relevant issue before the Court of Appeal was whether California constitutionally could include the sales of nontaxable corporations in the sales factor of the apportionment formula, an issue that Petitioner has conceded in this case.

A. A State Simply Cannot Tax Income over Which It Has No Power to Tax, Even if Such Income Is Properly Apportioned to the State

Formula apportionment is merely a device for determining the amount of income of a unitary group that is attributable to activity within a State, *see, e.g., Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207, 223 (1980); it is not determinative of whether the State has the power to tax such income. Indeed, it is an axiomatic principle of state taxation that a State may only tax income or property that is within its taxing power. *See, e.g., Miller Bros. Co. v. Maryland*, 347 U.S. 340, 342 (1954) ("It is a venerable if trite observation that seizure of property by the state under pretext of taxation when there is no jurisdiction or power to tax is simple confiscation and a denial of due process of law"); *see also New York, Lake Erie & W. R.R. Co.* v. *Pennsylvania*, 153 U.S. 628, 646 (1894); *St. Louis v. Ferry Co.*, 78 U.S. 423, 430 (1871). Congress, in exercising its power to regulate interstate commerce, limited the States' power to tax a corporation's income from interstate commerce if the corporation's sole activity in the State is the solicitation of orders. 15 U.S.C. § 381; *see also Heublein*, 409 U.S. at 278; *Wis. Dep't of Rev. v. William Wrigley, Jr., Co.*, 505 U.S. 214, 223 (1992).

It is, of course, "a just and well-settled doctrine established by this court, that a State cannot do that indirectly which she is forbidden by the Constitution to do directly." *Passenger Cases*, 48 U.S. 283, 458 (1849) (plurality opinion). This Court has consistently applied this "great principle" (*id.* at 459) to invalidate state exactions

that purport to tax indirectly what the Constitution forbids States from taxing directly. *See, e.g., id.* (striking down an exaction on foreign passengers as a prohibited "duty of tonnage," U.S. Const. art. I, § 10, cl. 3); *Hunt-Wesson, Inc. v. Franchise Tax Bd.*, 528 U.S. 458, 464-65 (2000) (striking down a rule that increased the amount of taxable income – through the reduction of a deduction – by precisely the amount of nontaxable income that the taxpayer has received, as an "impermissible tax"); *Frick v. Pennsylvania*, 268 U.S. 473, 495 (1925) (striking down state estate tax on the ground that "[i]t would open the way for easily doing indirectly what is forbidden to be done directly, and would render important constitutional limitations of no avail"); *Lee v. Osceola & Little River Rd. Improvement Dist. No. 1*, 268 U.S. 643, 645 (1925) (striking down state tax scheme that would "accomplish indirectly the collection of a tax against the United States which could not be directly imposed").

California's method of determining Deluxe's taxable income in this case is a paradigmatic example of a State's effort to tax indirectly that which it cannot tax directly. Under California's tax scheme, if Deluxe, Current, and Colwell were all taxable by California, the State would have assigned part of the unitary group's California income on a pro rata basis to each corporation and determined any tax separately for each corporation. *See* Cal. Franchise Tax Bd., Legal Ruling No. 234 (App. 47a). However, solely because of Current's and Colwell's tax immunity, the State employed the artifice that those corporations earned zero income in California, and arbitrarily shifted their California income to Deluxe. *See* Cal. Franchise Tax Bd. Notice No. 90-3 (App. 42a). There is no

logical or reasoned basis for this latter rule other than to strip income from nontaxable corporations and assign it to a taxable corporation. Because the shifting of income from Current and Colwell depends solely on the taxability of those corporations, the effect is simply to tax the income of immune corporations.

B. California's Tax Scheme Evades the Letter and Spirit of Public Law 86-272

There is little doubt that California's tax scheme operates to evade the letter and the spirit of Public Law 86-272. In this case it has been stipulated that Public Law 86-272 prevents California from taxing Current's and Colwell's California income. Thus, it is clear that California cannot circumvent the mandate of Public Law 86-272 by creating the fiction that Current and Colwell earned none of the group's California income and Deluxe earned all of such income. Indeed, even the trial court in this case readily acknowledged this effect: "Deluxe provides numerous examples which *accurately reflect how Deluxe is paying taxes on income generated in California by Current and Colwell*" (Statement of Decision, App. 21a (emphasis added)), and "It is undeniable that Current and Colwell have contributed to the unitary group's California source income." (*Id.* at App. 25a.) By shifting income from an immune corporation to a taxable corporation, the amount of a unitary group's income taxed by California remains the same regardless of whether a portion of that income is earned by a corporation immune from taxation under

Public Law 86-272. This is a clear violation of Public Law 86-272.

In *Heublein*, 409 U.S. 275, this Court recognized that States could easily circumvent the protection of Public Law 86-272 to evade the intent of Congress, and thus warned that "[i]f we were persuaded that South Carolina has evaded the intent of [Public Law 86-272] we would, of course, be reluctant to uphold its actions." *Id.* at 279. In that case, the Court considered whether a state law that required out-of-state sellers of alcoholic beverages to maintain an in-state representative to receive orders violated the intent of Public Law 86-272 by forcing out-of-state companies to engage in activities exceeding the mere solicitation of goods. This Court determined that the regulation did not offend or evade the intent of Public Law 86-272 because of the state's special interest in regulating the sale of alcoholic beverages and because the regulation was merely a part of a broad regulatory scheme. The Court's warning, however, served to put States on notice that circumvention of the protections of Public Law 86-272 would not be tolerated.

This Court's warning is directly applicable in this case. It is undeniable that the challenged rule "evades the purpose" of Public Law 86-272. California's rule deprives a corporation of the protection of Public Law 86-272. However, the rule at issue here has none of the redeeming features of the South Carolina law upheld in *Heublein*. California's rule is not part of a broad regulatory scheme, and it serves no purpose other than to allow California to tax income protected by Public Law 86-272.

In sum, there simply is no justification or reasoned basis for a rule that assigns income on a pro rata basis to Current and Colwell if they are taxable, but shifts their income to Deluxe if those corporations are immune from tax. As this Court once put the matter, "a tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes." *Trinova Corp. v. Mich. Dep't of Treasury*, 498 U.S. 358, 374 (1991) (citation omitted). Similarly, a tax on Deluxe measured by the California income of Current and Colwell is a tax on Current and Colwell.

II. THE QUESTION PRESENTED HAS WIDESPREAD SIGNIFICANCE AND SHOULD BE RESOLVED TO AVOID UNDERMINING FEDERAL RESTRAINTS ON STATE TAXATION

The issues raised here potentially affect every multistate taxpayer in the country as well as every State that uses the unitary method of taxation. Public Law 86-272 is an important federal limitation on states' taxing power and was enacted with the primary purpose of bringing clarity to when a State may tax interstate commerce. *See Heublein*, 409 U.S. at 280. The lower court's decision destroys that clarity and threatens to render the protections afforded by Public Law 86-272 merely illusory.

Moreover, if a State is permitted to circumvent Public Law 86-272 simply by shifting income from an immune corporation to a taxable corporation, all federal limitations on the states' taxing power would be at risk. In this particular instance, if allowed to stand, the Court of Appeal's decision provides a roadmap for evading the

restrictions of Public Law 86-272. If a State can reach nontaxable income by the transparent device of shifting such income from a nontaxable corporation to a taxable corporation, then the bar on taxing such nontaxable corporations is meaningless. Yet that is precisely what California has done.

The impact of the Court of Appeal's decision is not merely theoretical. More than 40,000 corporations have filed income tax returns reporting activities inside and outside California, and thus are potentially affected by the lower court's decision. In addition, at least 14 States utilize the unitary business/formula apportionment method of taxation. *See* Hellerstein, *supra* at ¶ 8.11[3], p. 8-194 n. 819. If the decision below is left undisturbed, it will pave the way for every State to avoid Public Law 86-272, as well as the constitutional limitations on its taxing powers. The decision below, after all, stands for a proposition of astonishing breadth: A State may increase a taxpayer's income merely by shifting income from a nontaxable corporation to a taxable corporation, even where it is clear that such income is attributable to the nontaxable corporation's activities. Moreover, the States are well aware of this issue – at least four other States have adopted tax schemes similar to that at issue here (*see* footnote 1), and California's rule has been the topic of frequent discussion in the state tax literature.[4]

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[4] *See, e.g.*, Ruurd G. Leegstra & Fred O. Marcus, *Joyce Overturned – Justice Denied?*, Journal of California Taxation, Summer 1990, at 5, and Pierre Vogelenzang, *Second-Stage Apportionment of Unitary Income*, Tax Notes, Oct. 15, 1990, at 335.

In short, the decision below has implications not only for every state taxpayer engaged in a unitary business, but also for state tax administrators. Unless quickly repudiated, the California Court of Appeal's decision will allow California to tax income that is immune under federal law, and is likely to embolden other States to follow California's lead. In these circumstances, this Court should grant review of the decision below.

CONCLUSION

For the reasons set forth above, the petition for certiorari should be granted.

Respectfully submitted,

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APPENDIX A

NOT TO BE PUBLISHED IN OFFICIAL REPORTS

IN THE COURT OF APPEAL OF THE
STATE OF CALIFORNIA

FIRST APPELLATE DISTRICT

DIVISION TWO

DELUXE CORPORATION,	
Plaintiff and Appellant,	**A088142**
v.	**(City & County of S.F. Super. Ct. No. 991237)**
FRANCHISE TAX BOARD,	
Defendant and Respondent.	**(Filed Apr. 26, 2001)**

I.

INTRODUCTION

In this corporate franchise tax refund case, Deluxe Corporation (Deluxe) sought to recover from the Franchise Tax Board (FTB) a refund of $638,269.34, plus applicable interest, for income years ending December 31, 1988, and December 31, 1989. Deluxe appeals from a decision of the superior court after a nonjury trial in favor of the FTB. We affirm the trial court's judgment. We conclude, as did Division One of this district in *Citicorp North America, Inc. v. Franchise Tax Bd.* (2000) 83 Cal.App.4th 1403 (*Citicorp*), that in calculating the amount of income apportionable to California operations under the rule in effect at the time Deluxe filed its tax return, the FTB properly included the California sales of

Deluxe's wholly owned subsidiaries, even though they did not have a taxable nexus to California.

II.

Facts and Procedural History

The facts of this case are not in dispute. The parties submitted a joint stipulation of facts to the trial court regarding the relevant facts, which are summarized as follows:

Deluxe is a corporation organized and existing under the laws of Minnesota, with its principal place of business in Minnesota. During the years at issue – income years ending December 31, 1988, and December 31, 1989 – Deluxe primarily manufactured and sold checks to businesses throughout the United States. Deluxe also sold financial forms to financial institutions and operated manufacturing plants. Deluxe was a California taxpayer and filed California tax returns.

Deluxe was engaged in a unitary business[1] with several corporations, including two wholly owned subsidiaries, Current, Inc. (Current) and Colwell Systems, Inc. (Colwell). Current was a Delaware corporation that conducted a mail order business, with all of its property and employees located at its principal place of business in the State of Colorado. Colwell was a Delaware corporation that conducted a mail order business, with all of its

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[1] A unitary business is one that receives income "from or attributable to sources [both] within . . . [and] . . . without the state . . . ." (Rev. & Tax Code, § 25101.) All further undesignated statutory references are to the Revenue and Taxation Code.

property and employees located at its principal place of business in the State of Illinois. Neither Current nor Colwell was subject to California's franchise or income tax during the years at issue.

Deluxe timely filed California franchise tax returns on a combined basis for the years at issue. Under the unitary method of taxation as applied by California, the business income of each entity is included in the combined report, and an apportionment formula is applied to the unitary business income to derive the group's income from California sources. (See generally *Safeway Stores, Inc. v. Franchise Tax Board* (1970) 3 Cal.3d 745, 751-752.) Upon audit, the FTB recomputed the corporate franchise tax liability of Deluxe and its affiliates after determining the California business activities of the Deluxe unitary group had been miscalculated.

As a result of the FTB's actions, Deluxe filed suit for a tax refund in the San Francisco Superior Court. In doing so, Deluxe sought to recover from the FTB a refund of $638,269.34 corporate franchise tax and interest paid for the taxable years ending December 31, 1988, and December 31, 1989. The parties submitted a joint stipulation and exhibits to the trial court regarding the relevant facts. After a court trial was held, the trial court issued a statement of decision, deciding in favor of the FTB in all respects. Pursuant to a stipulation of the parties, Deluxe was awarded the refund of an overpayment of interest in the amount of $11,579. Deluxe has appealed.

III.

Discussion

Background on Different Methods of Income Apportionment

The various questions presented by this appeal relate to the formula by which the Board determined what portion of Deluxe's multi-state unitary business income was properly attributable to California sources and subject to California franchise taxes. If a unitary business exists, taxes are apportioned by formula so that California can recover "its fair share of the taxable values of the taxpayer . . . ." (*Butler Brothers v. McColgan* (1941) 17 Cal.2d 664, 667-668, aff'd. (1942) 315 U.S. 501 (*Butler Brothers*).) In calculating corporate franchise taxes of a unitary interstate business, the FTB apportions the business income attributable to California by means of a complex three-factor formula based on property, payroll and sales. (§ 25128.)

In the disputed returns, Deluxe excluded the California sales of Current and Colwell from the apportionment formula used to determine the portion of the unitary group's business income attributable to California sources because Current and Colwell were not California taxpayers. In excluding Current and Colwell's California sales from the apportionment formula sales calculation, Deluxe was following the rule first enunciated by the State Board of Equalization (SBE) in *Appeal of Joyce, Inc.* (Nov. 23, 1966) [1966-1971 Transfer Binder] Cal. Tax Rptr. (CCH) ¶ 203-523, pp. 13,115-13,118) (hereafter *Joyce*). The *Joyce* opinion held that sales to California customers by an out-of-state seller who was not subject to California

tax in its individual capacity would be excluded in the apportionable tax base even though the out-of-state seller was part of a unitary group, which included another member subject to California tax. In following the *Joyce* method of apportionment, Deluxe attributed less income to its California activities and concomitantly reduced its California tax liabilities.

After an audit, the FTB determined that, consistent with the rule then being applied by the FTB, the California sales of Current and Colwell should be included in the apportionment formula used to determine the portion of Deluxe's business income attributable to California sources. The FTB's determination was guided byhe [sic] method of apportionment regarding unitary business groups enunciated in the SBE's ruling in *In re Appeal of Finnigan Corporation* (Aug. 25, 1988) Cal. Tax Rptr. (CCH) [1986-1990 Transfer Binder] ¶ 401-653, pp. 25,241-25,243 (hereafter *Finnigan I*); opn. on petn. for rehg. (Jan. 24, 1990) Cal. Tax Rptr. (CCH) [1986-1990 Transfer Binder] ¶ 401-797, pp. 25,755-25,757 (hereafter *Finnigan II*) (opinions collectively referred to as *Finnigan*). *Finnigan* was a 1990 SBE decision that specifically overruled *Joyce* and applied its ruling retroactively to the tax years at issue in this case, 1988 and 1989. *Finnigan* held that *Joyce* contravened fundamental unitary tax theory by preventing assignment of an out-of-state corporation's sales to a destination state where at least one unitary group member was subject to tax in the state. On June 8, 1990, the FTB issued FTB "Notice No. 90-3," which affirmed the ruling in *Finnigan* and overruled the *Joyce* doctrine. In following the *Finnigan* method of apportionment, the FTB treated all Deluxe affiliates as a unitary taxpayer and

included income generated in California by Current and Colwell in the apportionment formula because Deluxe, a member of the unitary group, was taxable in the state even though Current and Colwell were not themselves taxable.

Thereafter, the SBE issued its opinion in *In re Appeal of Huffy Corporation*, (Cal. State Tax Rptr. (CCH) 1995-1999 transfer binder, [¶] 403-031). In *Huffy*, the position established in *Finnigan* was abandoned and the rule established in *Joyce*, was prospectively readopted for income years beginning on or after April 22, 1999. *Joyce* was readopted to more fairly reflect fundamental principles of unitary business group combined reporting, and to promote Uniform Division of Income for Tax Purposes Act (UDITPA) consistency.[2] The ruling's prospective rather than retroactive application recognized past reliance on the *Finnigan* decision and deprived Deluxe of the benefit of the *Joyce* rule.

Was it Error to Use the Finnigan Income Apportionment Methodology in this Case?

Primarily, Deluxe argues that the method the FTB used to compute its tax set forth in the *Finnigan* decision was unlawful because it had the effect of taxing Deluxe with respect to income derived from Current and Colwell, sources beyond the taxing jurisdiction of the State. Deluxe argues: "This was accomplished by assigning all

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[2] The UDITPA has been adopted by over 20 states and was enacted in California in 1966. The expressed general purpose of UDITPA is to standardize state corporate income tax laws and to make uniform the law of those states that enact it. (§ 25138.)

of the group's California apportioned income, including that of Current and Colwell, entirely to Deluxe, simply because Deluxe was taxable by California while Current and Colwell were not. Appellant challenges this assignment as indirectly taxing Current's and Colwell's income in violation of [Pub.L. No.] 86-272[3] and the Commerce and Due Process Clauses of the United States Constitution." (Footnote added.)

Any need to analyze the myriad of arguments made by Deluxe in support of its position on appeal has been made unnecessary by Division One's recent decision in *Citicorp*, a case that mirrors the one before us. Our Supreme Court recently denied review of *Citicorp* on January 10, 2001. In *Citicorp*, the Court of Appeal ruled that credit card sales to California customers by Citicorp's South Dakota affiliate, which was not itself taxable in the state, were properly included in the measure of Citicorp's California taxpayers' income attributable to California sources and that doing so did not unconstitutionally tax the income of the South Dakota affiliate. In so ruling, the court considered and rejected the bulk of the arguments raised by Deluxe herein to application of the *Finnigan* rule of apportionment. We hereby adopt the well-reasoned analysis of *Citicorp* and find that analysis effectively disposes of the arguments made by Deluxe on appeal.

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[3] Public Law No. 86-272 allows a company to solicit sales in a state without becoming subject to taxation in that state as long as the order acceptance, the order filling, and shipment are in another state. Under Public Law No. 86-272, these sales are "thrown back" to the shipping state for taxation, rather than being included in the destination state for taxation.

Most importantly, *Citicorp* gave an unmistakably clear answer to the main argument made by Deluxe in this appeal – that the *Finnigan* rule of apportionment is inconsistent with federal and state law because it results in unconstitutional taxation. The *Citicorp* court unanimously repudiated Citicorp's contention that the *Finnigan* rule of apportionment amounts to an illegal, "indirect" tax on the income of the South Dakota affiliate. In doing so, the court relied on *Edison California Stores v. McColgan* (1947) 30 Cal.2d 472 (*Edison*), which held "that to compute the income allocable to one state of a unitary business operated in several states by a reasonable formula method is not to tax extraterritorial values." (*Id.* at p. 483, citing *Butler Brothers, supra,* 315 U.S. at p. 507.) Invoking *Edison*'s reasoning, *Citicorp* concluded that, "by considering the California income of Citibank (South Dakota), the FTB is not taxing, but is apportioning income attributable to California. [Citation.] Taxes are actually imposed only on the corporations that are subject to California's taxing jurisdiction." (*Citicorp, supra,* 83 Cal.App.4th at p. 1415.) The court found *Edison* to be "a clear response to Citicorp's claim that consideration of the out-of-state affiliate's California activity results in extraterritorial taxation." (*Ibid.*, fn. omitted.)

In so holding, *Citicorp* reaffirmed the long-established distinction between apportionment of income and the taxation of income. Recognizing this distinction, the court determined that the income of Citibank (South Dakota) was not being taxed indirectly by California, but was simply being considered in the measure of tax, i.e., in determining the amount of Citicorp's business income attributable to California sources. The court's opinion

reflects its understanding that the *Finnigan* rule is fully consistent with the fundamental notion that the unitary business principle does not implicate a state's jurisdiction to tax, but addresses only the subject of apportionment, i.e., the proper measure of a unitary group's level of business activity in the state.

Consequently, for purposes of apportionment of unitary business income in a combined report, it is simply irrelevant whether California has a jurisdictional nexus to tax Current and Colwell, or any other member of Deluxe's unitary group. The underlying premise of formula apportionment is to arrive at an amount that fairly reflects the taxpayer's business activity in California. By applying principles of combined reporting and formula apportionment, California seeks only to determine the income attributable to California generated by the members of Deluxe's unitary group. As recognized by *Citicorp*, "Taxes are actually imposed only on the corporations that are subject to California's taxing jurisdiction." (*Citicorp, supra*, 83 Cal.App.4th at p. 1415.) In short, by applying the *Finnigan* methodology, California does not seek to tax any individual member of Deluxe's unitary group not otherwise subject to tax in the state.

Furthermore, we accept *Citicorp*'s holding that UDITPA's stated objective of making uniform the law of those states which have enacted its provisions represents nothing more than a stated goal. Although certainly a legitimate objective, uniformity does not constitute an independent legal ground on which to invalidate a method of apportionment. As the *Citicorp* court stated: "[t]he mere fact that other bodies and jurisdictions did not follow the *Finnigan* rule is not a valid basis for this

court to disregard the considered decision of a constitutionally created quasi-judicial administrative agency." (83 Cal.App.4th at p. 1418.)

The *Citicorp* court also rejected the argument that the FTB's application of the *Finnigan* rule violated the commerce clause, the due process clause and the equal protection clause of the United States Constitution. In considering the constitutional claim, Citicorp stated "[t]here was no evidence indicating that application of *Finnigan* distorted the percentage of income fairly allocable to California. Rather, the evidence reflected the reasonable apportionment of sales generated in California." (83 Cal.App.4th at p. 1425.) Furthermore, exposure to duplicative taxation resulting from a lack of uniformity among the states does not present a constitutional question. The court observed, "Prevention of such possibilities of duplicative taxation would require adoption of a national uniform code, a task the court found better suited to an exercise of the legislative, than the judicial power. [Citations.] Plainly, the Constitution does not mandate that every state treat every item of income alike and assign the apportionment of sales in a uniform manner." (*Ibid.*) Thus, when a state's method of apportionment represents a rough approximation of a corporation's income that is reasonably related to the activities conducted within the taxing state, no constitutional violation exists.

The *Citicorp* decision also addresses Deluxe's fallback argument that "assuming, arguendo, that the FTB's method of apportionment and assignment of income [pursuant to *Finnegan*] does not violate Cal. Rev. & Tax. Code § 25138, [Pub.L. No.] 86-272 or the Constitution,

nevertheless that methodology should not be applied retroactively to the years at issue." In *Citicorp*, the court undertook a thorough and thoughtful analysis of the administrative history of the SBE's decisions in *Joyce*, *Finnigan*, and *Huffy*. (83 Cal.App.4th at pp. 1412-1414.) The court traced the initial adoption of the *Joyce* rule in 1966, the abandonment of the *Joyce* rule in favor of *Finnigan* in 1988, and the recent return to the *Joyce* rule in *Huffy*. The court recognized the SBE's flip-flop in its decisions "is not evidence that either interpretation was legally impermissible. [Citation.]" (*Id.* at p. 1419.) While acknowledging that the *Finnigan* rule was eventually abandoned, the court resoundingly rejected Citicorp's claim that *Finnigan* was poorly reasoned and should be given no weight. To the contrary, *Citicorp* found the "SBE decision in *Finnigan* was supported by reference to the relevant statutes and regulations, and a reasoned analysis of the issues." (*Id.* at p. 1420.) With regard to the FTB's decision, pursuant to Notice 90-3, to apply *Finnegan* retroactively, the court noted, "[r]etroactive application of *Finnigan* was an exercise of the prevailing rule regarding changes in the law." (*Id.* at p. 1423.) In short, the court rejected Citicorp's request to "adjust the agency's reasoned resolution of the application of its own rules." (*Id.* at p. 1424.)

Therefore, in accordance with the reasoning in *Citicorp*, we hold the apportionment methodology applied by the FTB to the years at issue under the *Finnigan* rule was fairly calculated to assign to California that portion of the unitary enterprise's income reasonably attributable to the business done here. This conclusion remains true even in light of the fact that the FTB has abandoned the

Finnigan approach and reverted to *Joyce*. Deluxe therefore is not entitled to any refund of the taxes it has paid for the years at issue.

IV.

Disposition

The judgment is affirmed.

Ruvolo, J.

We concur:

Kline, P.J.

Lambden, J.

APPENDIX B

IN THE SUPERIOR COURT OF
THE STATE OF CALIFORNIA

IN AND FOR THE COUNTY OF SAN FRANCISCO

DEPARTMENT NUMBER 304

Deluxe Corporation, a Minnesota Corporation, Plaintiff, vs. Franchise Tax Board, an agency of the State of California, Defendant.	Case No. 991237 STATEMENT OF DECISION (FILED MAY 26, 1999)

Plaintiff, Deluxe Corporation ("Deluxe") seeks to recover from defendant, Franchise Tax Board ("FTB"), a refund of $638,269.34 corporate franchise tax and interest paid for the taxable years ended December 31, 1988 and December 31, 1989. The matter was submitted based on a Joint Stipulation of Facts ("JS"), from which the summary set forth below is drawn. All facts pertain to the income years ending December 31, 1988 and December 31, 1989.

Summary of the Facts

Deluxe is a corporation organized and existing under the laws of Minnesota, with its principal place of business in Minnesota. (JS ¶ 1.) Deluxe primarily manufactured and sold checks to businesses throughout the United States. (JS ¶ 5.) Deluxe also sold financial forms to financial institutions and operated manufacturing plants. (JS

¶ 5.) Deluxe was a California franchise tax payer, and timely filed California franchise tax returns. (JS¶ 7.)

Deluxe was engaged in a unitary business with several corporations, including two wholly-owned subsidiaries, Current, Inc. ("Current") and Colwell Systems, Inc. ("Colwell"). (JS ¶s 6, 15, 19.) Current was a Delaware corporation which conducted a mail order business, with all of its property and employees located at its principal place of business in Colorado. (JS ¶ 15.) Colwell was a Delaware corporation which conducted a mail order business in the State of Illinois. (JS ¶ 19.) Neither Current nor Colwell was subject to California's corporation franchise or income tax during the years at issue because the activities of Current and Colwell in California did not exceed the activities described in subsections (1) and (2) of 15 U.S.C. §381(a) ["Public Law 86-272"]. (JS ¶ 18.)

During the years at issue, Deluxe filed California franchise tax returns and determined its California net income by preparing a combined report. (JS ¶ 7.) The combined report included the business income of all members of the Deluxe unitary group. (JS ¶ 7.) Pursuant to the method of apportionment set forth in *Appeal of Joyce*[1] and FTB Legal Ruling No. 234, Deluxe excluded the California sales of Current and Colwell from the numerator of the California sales factor used to determine the portion of the unitary group's business income attributable to California sources. (JS ¶8.)

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[1] *Appeal of Joyce, Inc.*, Cal. St. Bd. of Equal., November 23, 1966

After an audit, the FTB determined that pursuant to the method of apportionment set forth in *Appeal of Finnigan*[2] and FTB Notice 90-3, the California sales of Current and Colwell should be included in the numerator of the California sales factor used to determine the portion of the unitary group's business income attributable to California sources. (JS ¶ 9.)

Pursuant to FTB Notice 90-3, the FTB then assigned all of the unitary group's California apportioned business income to Deluxe, the member of the unitary group taxable in California, and assigned none of that income to Current and Colwell. (JS ¶ 23.) None of the group's California income was assigned to Current or Colwell because they were not taxable by California. (JS ¶24.)

Background Information

The California franchise tax is essentially a tax measured by the net income of a corporation for the privilege of doing business in California. (Rev. & Tax Code §§ 23151, 23151.1.) California employs the "combined reporting method" or "unitary method" of corporate taxation to determine a corporation's California net income. (*Container Corp. v. Franchise Tax Bd.* (1983) 463 U.S. 159, 162-163.)

The unitary method of taxation involves three steps. First, the corporate taxpayer must determine with which

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[2] *Appeal of Finnigan Corporation* [*Finnigan I*], No. 88-SBE-022, Cal. Tax RPTR. (CCH) ¶ 401-652 (Aug. 25[,] 1988), and *opinion on reh'g., Appeal of Finnigan Corporation* [*Finnigan II*] No[.] 88-SBE-022-A, Cal. Tax Rptr. (CCH) ¶ 401-797 (Jan. 24, 1990).

affiliated corporations, if any, it is engaged in a unitary business. Second, the taxpayer must determine the unitary group's business income. Third, the taxpayer must apportion the corporation's unitary business income to determine its California taxable income. (*Id.* at 165.)

The apportionment of the unitary group's business income is itself a four step process which involves the application of a statutory three-factor apportionment formula. In Step One, the three-factors which are used in the apportionment formula are calculated. (Cal. Rev & Tax. Code §25128.) These are a sales factor, a property factor, and a payroll factor. Only the sales factor is at issue in this case. The sales factor is a fraction consisting of California sales in the numerator, and aggregate world-wide sales in the denominator. In Step Two, the fractions for each of the three factors are added together and divided by three to derive an average of the three factors. In Step Three, referred to as "interstate apportionment," the resulting apportionment fraction is multiplied by the unitary group's business income to derive the business income apportioned to California. In Step Four, referred to as "intrastate assignment," the business income apportioned to California is assigned to the individual members of the unitary group.

Prior to 1990, the method of apportionment utilized by the FTB was consistent with the method urged by Deluxe. From 1966 until 1990, the FTB applied the *Joyce* Rule. (JS ¶ 24.) Under *Joyce*, the California sales of a member of a unitary group immune from California tax under Public Law 86-272, are excluded from the numerator of the California sales factor.

In 1990, the FTB changed its practice and began employing the methodology set forth in the *Finnigan* decisions and FTB Notice 90-3. Under the new practice, if any member of the unitary group is taxable in California, the California sales of all members of the unitary group are included in the numerator of the California sales factor.

Recently, the FTB has tentatively adopted a new regulation, section 25106.5 of Title 18 of the California Code of Regulations, which expressly adopts the *Joyce* rule and rejects the apportionment methods in *Finnigan* and Notice 90-3, thus reverting to the pre-1990 policy.[3] This regulation is now in a 45-day notice period, to allow for public comment and an opportunity for further hearings. See also *Appeal of Huffy* (1999) 96R-1263, pp. 15-16, *infra*.

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[3] The latest FTB change of policy is of little relevance to the outcome of this matter. The unitary business concept is flexible and susceptible to varying interpretations. (*Container Corporation of America v. Franchise Tax Board* (1983) 463 U.S. 159, 167 ("A final point that needs to be made about the unitary business concept is that it is not, so to speak, unitary: there are variations on the theme, and any number of them are logically consistent with the underlying principles motivating the approach.")) As long as the approach employed by the FTB at any given time satisfies the constitutional requirements, is consistent with applicable federal and state statutes, and is uniformly applied, the methodology will be upheld. The FTB has the flexibility to change methodology as it sees fit.

Discussion

Deluxe, as the plaintiff, has the burden of affirmatively establishing a right to a tax refund by a preponderance of the evidence. (*Consolidated Accessories Corp. v. Franchise Tax Bd.* (1984) 161 Cal.App.3d 1036, 1039.) Deluxe has attempted to carry that burden by challenging the apportionment scheme utilized by the FTB for the years in question as a violation of Public Law 86-272 and of the Commerce and Equal Protection Clauses of the United States Constitution.

I. Did the Board of Equalization in *Finnigan* improperly determine the meaning of "taxpayer" for purposes of the throw-back rule?

As a preliminary argument, Deluxe contends that in *Finnigan* the Board of Equalization improperly read "taxpayer" to include any member of the unitary group for purposes of the throw back rule. (Cal. Rev. & Tax. Code §25135(b)(2).)[4] The throw back rule relates to the computation of the sales factor of the apportionment formula. Ordinarily, sales of tangible personal property made to California customers are assigned to California under the "destination rule". However, such sales are assigned, or "thrown back", to the shipping state if the seller is not

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[4] Section 25135(b[])(2) reads in pertinent part:

Sales of tangible personal property are in this state if:

(b) The property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) . . .or (2) the taxpayer is not taxable in the state of the purchaser.

taxable in California. Under *Joyce*, the throw back rule was applied where the individual taxpaying corporation was not subject to tax in the destination state. However, under *Finnigan*, California sales should not be thrown back to the shipping state if any member of the unitary group was subject to tax in California.

In *Finnigan I* the court stated:

> "We believe that basic unitary theory requires us to conclude that, as used in section 25135, subdivision (b)(2), "taxpayer" means all corporations within the combined unitary group. To hold otherwise would result in an apportionment formula which produced a different tax effect where the unitary business was conducted by the divisions of a single corporation than where it was conducted by multiple corporations. No difference is discernible in the two situations. The California Supreme Court has told us that as far as unitary theory is concerned the same rule should apply whether the integral parts of the unitary business are or are not separately incorporated. (*Edison California Stores, Inc. v. McColgan* (1947) 30 Cal.2d 472, 473.)" (*Appeal of Finnigan*, No. 88-SBE-022, 1988 Cal. Tax LEXIS 28, 6.)

Deluxe argues that this interpretation of "taxpayer" is inconsistent with the plain language of Section 25135 and the surrounding sections of the Uniform Division of Income for Tax Purposes Act (UDITPA). Deluxe asserts that "all of the substantive and definitional provisions embodied in UDITPA, which determine the share of a taxpayer's income that is attributable to California, refer to the taxpayer or a taxpayer in the singular."

The FTB, however, refers to a number of sections in UDITPA which define taxpayer to include not only individual corporations but also all corporations within a unitary group. One example relied upon by the FTB is Section 25121, which provides that any taxpayer having income from business activity which is taxable both within and without the state shall apportion its net income as provided in the UDITPA provisions.

This court must agree with the observation in *Finnigan* that "it is apparent that the term taxpayer as used in UDITPA is multifaceted." (*Id.* at 6.) If otherwise required, the term is broad enough to include all of the members of a unitary group.

II. Does the apportionment methodology set forth in FTB Notice 90-3 violate Public Law 86-272?

FTB Notice 90-3, which draws its authority from the *Finnigan* decisions, provides that if any member of a unitary group is taxable in California, the California sales, property, and payroll factors of all members of the unitary group are included in the numerators of the respective California factors. The resulting California apportioned business income is then assigned to those members of the unitary group subject to tax in the State.

Public Law 86-272 (15 U.S.C. §381) prohibits a state from imposing a tax on income derived from the sale of tangible personal property where (1) the seller's only activity in the state consists of the "solicitation of orders," (2) the orders are sent out of state for approval, and (3) delivery/shipment is made from a point outside the state. The parties have stipulated that the activities of Current

and Colwell in California did not exceed the activities described in Public Law 86-272 and, accordingly, they were not subject to taxation in California.

Deluxe contends that under the FTB's approach, the same amount of the unitary group's income is taxed as would occur without the subsidiaries' tax immunity, so that the FTB has effectively manipulated the apportionment formula to tax indirectly income which California cannot tax directly. (See *Frick v. Pennsylvania* (1925) 268 U.S. 473.) To illustrate this point, Deluxe provides numerous examples which accurately reflect how Deluxe is paying taxes on income generated in California by Current and Colwell. The FTB acknowledges that "the effect of the *Finnigan* rule is that California destination sales of Current and Colwell, entities exempt from taxation under Public Law 86-272, are considered in determining the amount of income of the unitary group which is apportioned to California but that those sales are disregarded when the California source income is divided between the members of the group actually subject to taxation by the process of intrastate apportionment." (FTB Trial Brief at p. 29.)

In *Finnigan II*, the court specifically addresses the dramatic change in reasoning from the earlier *Joyce* decision:

> To those well versed in unitary matters, Joyce undeniably contravenes fundamental unitary theory in two important respects. First, by forbidding the assignment of sales to the state of destination in situations where at least one member of the unitary group is taxable in that state, but the actual seller is not, the Joyce rule

> defeats the basic purpose of the sales factor, which is to reflect the markets for the unitary business's goods and services. (see Altman and Appeals of Pacific Telephone and Telegraph Company, Cal. St. Bd. of Equal., May 4, 1978.) Second, by focusing on the state's jurisdiction to tax the seller as a separate corporate entity, the rule elevates form over substance by yielding a different apportionment result dependent solely on whether the unitary business is conducted by several corporations or only by one.

This court agrees that FTB notice 90-3 does not impermissibly tax the income of an immune entity. Public Law 86-272 is directed to the authority of a state to impose a tax, and places a limit on that power where a particular corporation limits its contact with a state to certain specified activities:

> "No State . . . shall have power to impose . . . a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following: . . ."

The statute does not expressly prohibit a state from using the income of a non-taxable entity for purposes of apportionment if another member of a unitary group of which it is a part conducts the requisite in-state activity. Nor is the apparent intent of the statute inconsistent with treating the unitary group as a whole for purposes of apportioning a corporation's taxable income to a particular state. If some member of the group conducts the requisite degree of activity within a state such as California, that member of the unitary group has subjected itself to the taxing authority of that state, and apportionment of the

unitary group's income to that taxpayer would not seem to circumvent the spirit of the statute, so long as the apportionment formula is reasonable. Only if the non-taxable entity is in fact independent of any other entity subject to the state's taxing authority would the purpose of the statute seem to preclude the state from considering the non-taxable entity's income in this manner. Certainly Deluxe has not cited any case law or legislative history indicating that such apportionment contravenes the statute.[5]

Instead, Deluxe contends that unitary theory does not sanction disregard of the form of corporate organization, observing that in other situations corporations with multiple divisions may be taxed differently than those with separately incorporated subsidiaries. To illustrate this point, Deluxe provides a number of examples in which taxation varies depending on the organization of the corporations.[6] Notwithstanding these examples,

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[5] To the contrary, see *Airborne Navigation Corporation v. Arizona Department of Revenue* (1987) No. 395-85-I Arizona Board of Tax Appeals, holding that appellant did not qualify for the exemption provided by Public Law 86-272 because the unitary group had sufficient business presence in Arizona to be subjected to Arizona taxing jurisdiction. In reference to the immunity provided by Public Law 86-272 the court stated that it would not be stretching the definition of "person" in the statute to say that appellant and the other corporations in the unitary group could be considered one person.

[6] For example, Deluxe cites to Cal. Rev. & Tax Code §§ 24401 and 24416 which allow for a deduction for net operating losses carried forward from a previous year. Such deductions are available to an individual corporation, and its various divisions, but not to offset income of other separately incorporated members of the unitary group.

adherence to this distinction is not required. (*Edison California Stores, Inc. v. McColgan* (1947) 30 Cal.2d 472.) In discussing the applicability of unitary apportionment theory to corporate groups with differing forms of organization, the court in *Edison* stated:

> Thus the business is unitary regardless of the fact that in the *Butler Brothers* case there was but one corporation involved, owning as parts of the unitary system seven different branches in as many states, and that in the present case there is a parent corporation owning and controlling as units of one system fifteen different branches organized as corporations in as many states. No difference in principle is discernible. If the crux of the matter is to ascertain that portion of the business which is done within the state, then the same considerations justify the use of the formula allocation method in one case as in another.

Additionally the court observed:

> The ascertainment of income by the apportionment method is not necessarily a disregard of the corporate entity. . . [.] Formula allocation is merely a method of ascertaining the true income attributable to the plaintiff's business, and is a method of ascertainment authorized by the statute.

Unitary theory and formula apportionment are based on the principle that all corporations engaged in a unitary business should be treated as a single economic enterprise for state tax purposes. The unitary business principles of formula apportionment attempt to eliminate the complications of particular corporate relationships and

impose a "fair and reasonable" tax result.[7] Thus, it does not matter that one member of the unitary group is not subject to tax in a particular state. Its income and activities within that state nonetheless will be considered when determining the in-state income for those members of the unitary group that are subject to the state's taxing jurisdiction. It is undeniable that Current and Colwell have contributed to the unitary group's California source income. Therefore, the inclusion of their income in the apportionment formula is consistent with a rational application of unitary theory.

Finally, Deluxe contends that even if this court decides that the *Finnigan* decisions are correct, Notice 90-3 reaches impermissibly beyond the holding in *Finnigan* when it assigns the entire California share of the unitary group's income to Deluxe. This argument, however, ignores the reasoning behind the *Finnigan* decisions.

The intrastate assignment in Notice 90-3 effectuates the change enunciated in *Finnigan*. Were the state to proportionally assign a unitary group's income among the corporations comprising the group and apply a tax only on those who were California taxpayers, there would be no difference in the results derived under *Joyce* and under *Finnigan*. Bearing in mind the purpose of treating members of a unitary group in the same manner regardless of the form of their organization, it is consistent to include the income of all members for purposes of apportionment and to divide the tax liability among only

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[7] See Corrigan, "Finnigan's Wake or Joyce's? The Application of Unitary Principle to Combined Groups,["] 1 J. Cal. Tax. 5 (1989).

those members within the state's taxing jurisdiction. Clearly, Deluxe would be responsible for the tax burden of Current and Colwell if they were simply divisions of the Deluxe corporation, rather than individually incorporated subsidiaries. Accordingly, the principles of combined reporting may reasonably be considered to demand similar treatment.

II. Does the apportionment scheme set forth in FTB Notice 90-3 violate the Commerce Clause?

The United States Supreme Court set forth the test for determining when a state tax violates the Commerce Clause in *Complete Auto Transit, Inc. v. Brady*[,] 430 U.S. 274, 279 (1977). The test requires that a state tax should be sustained "against Commerce Clause challenge when the tax is [1] applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State." Deluxe raises challenges under the first three prongs of the *Complete Auto* test.

These challenges fail primarily because they rest upon a misunderstanding of unitary theory. This theory requires that the unitary group be viewed as a whole, the purpose being to effect the same tax treatment regardless of how the unitary group is internally organized.

A. *A substantial nexus exists between the unitary group and California such that taxation is proper.*

Deluxe contends that the apportionment methodology in FTB Notice 90-3 violates the first prong of the *Complete Auto* test because Current and Colwell do not have a substantial nexus with California such as to justify taxation. Substantial nexus essentially means that there be "some definite link, some minimum connection, between a state and a person, property or transaction it seeks to tax." (*Miller Bros. v. Maryland*, 347 U.S. 340, 344-345 (1954).) Deluxe's argument on this issue relates back to the earlier argument that the FTB is taxing Current's and Colwell's income indirectly via Deluxe.

For the same reasons discussed above, this argument is not persuasive. First, the inclusion of Current's and Colwell's sales income in the apportionment formula is not the imposition of a tax on Current and Colwell. Second, a substantial nexus does exist between the unitary group and California such that the inclusion of all California sales in the apportionment formula is permissible.

B. *The resultant tax is fairly apportioned.*

Deluxe contends that the apportionment methodology in FTB Notice 90-3 violates the second prong of the *Complete Auto* test because the resultant tax is not fairly apportioned. The fair apportionment requirement essentially means that the apportionment formula must have internal and external consistency. (*Container Corporation of America v. Franchise Tax Board* (1983) 463 U.S. 159, 169.)

Internal consistency means simply that the formula, if applied by every jurisdiction, would not result in more than 100% of the unitary business' income being taxed. (*Ibid.*) External consistency means that the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated. (*Ibid.*)

Deluxe argues that "[b]ecause only Deluxe's income is taxable by California, by importing Current's and Colwell's California sales into the formula used to apportion the unitary group's income to California and by then assigning all of the apportioned income solely to Deluxe, including that generated by Current and Colwell, the FTB has forsaken any claim that it simply has effected a "reasonable" apportionment of Deluxe's income. Additionally, Deluxe argues that the arbitrary assignment of all of the California income to Deluxe is not reflective of Deluxe's activities in California, and thus is out of all "appropriate proportion" to those activities.

Applying the *Container* test, there is no doubt that the apportionment formula has internal consistency. While the unitary group's California liability may increase, there would be a matching reduction in Colorado and Illinois source income, such that no more than 100% of the unitary group's income would be taxed. Furthermore, the formula is externally consistent in that the factors used – sales, property and payroll in the state – do reflect the means by which income is generated.

Deluxe's arguments to the contrary are not persuasive. The principles of unitary reporting require that the unitary group be taken as a whole. As such, the inclusion

of the income of Current and Colwell in the apportionment formula and the assignment of the resultant tax liability to Deluxe does not produce a result out of all proportion to their business conducted in California. In fact, the result is quite the opposite: it properly reflects a reasonable apportionment of the unitary group's California income, as calculated by accepted unitary business principles.

C. *Notice 90-3 does not discriminate against interstate commerce.*

Deluxe argues that the apportionment methodology in FTB Notice 90-3 discriminates against interstate commerce "by favoring those taxpayers that affiliate with corporations subject to tax in California over taxpayers that chose not to affiliate with corporations taxable in California," thereby violating the third prong of the *Complete Auto* test. (Deluxe's Trial Brief, p.17.) Specifically, by including Current's and Colwell's sales in the apportionment formula and then assigning the tax liability to only Deluxe, the individual tax liability of Deluxe increases simply because Current and Colwell are not California taxpayers.

Deluxe relies primarily upon *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996) in support of this contention. In *Fulton*, the Supreme Court invalidated a North Carolina taxing scheme which imposed an intangibles tax upon corporate stock, but allowed for a deduction equal to the percentage of the underlying corporation's income taxable within North Carolina. The Court stated that "[t]here is no doubt that the intangibles tax facially discriminates

against interstate commerce. A regime that taxes stock only to the degree that its issuing corporation participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among North Carolina residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce." Deluxe argues that, like the tax in *Fulton*, FTB Notice 90-3 "improperly coerces taxpayers like Deluxe to affiliate with California based corporations and discourages corporations subject to tax in California from investing in or otherwise affiliating with out-of-state corporations without taxable nexus with this State." (Deluxe's Trial Brief, p.20.)

Fulton, however, is distinguishable. The facts in *Fulton* do not involve unitary principles. In *Fulton*, the tax on an individual corporation's stock varied depending on the state of incorporation. Here, looking at Deluxe, Current and Colwell as part of a unitary group, the total tax on the group does not depend on their different states of incorporation. When the unitary group is viewed as a whole, the state's policy does not discriminate against interstate commerce. As such, the policy is not facially discriminatory.

This conclusion is further supported by the Court's additional comments in *Container Corporation of America v. Franchise Tax Board, supra*, 463 U.S. 159:

> Besides being fair, an apportionment formula must, under the Commerce Clause, also not result in discrimination against interstate or foreign commerce. Aside from forbidding the obvious types of discrimination against interstate or foreign commerce, this principle might

> have been construed to require that a state apportionment formula not differ so substantially from methods of allocation used by other jurisdictions in which the taxpayer is subject to taxation as to produce double taxation of the same income and resultant tax burden higher than the taxpayer would incur if its business were limited to any one jurisdiction. At least in the interstate commerce context, however, the antidiscrimination principle has not in practice required much in addition to the requirement of fair apportionment. (*Id.* at 170, internal citations omitted.)[8]

As discussed above, the state's policy is both internally and externally consistent and does not facially discriminate against interstate commerce. Accordingly, Deluxe's challenge under the Commerce Clause cannot prevail.

III. Does the apportionment scheme set forth in Notice 90-3 violate Equal Protection?

Deluxe acknowledges that "taxation ordinarily does not involve 'any suspect classification or the deprivation of any fundamental constitutional right' that gives rise to special scrutiny under the Equal Protection Clause. *See Harrah Indep. Sch. Dist. v. Martin* (1979) 440 U.S. 194, 199."

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[8] The Court felt that a contrary result would require the Court to establish "not only a single constitutionally mandated method of taxation, but also rules regarding the application of that method in particular cases." (*Id.* at 171.) Because this task was thought to be essentially legislative, the Court declined to adopt this approach. (*Ibid.*)

(Deluxe's Trial Brief at p. 24.) Accordingly, the rational basis standard is applied to measure the constitutionality of a particular tax under the Equal Protection Clause.

Nonetheless, Deluxe argues that Notice 90-3 creates an arbitrary and irrational classification based on whether or not a corporation is affiliated with other corporations subject to tax in California. (Deluxe's Trial Brief at p. 25.) This is essentially the same argument raised under the Commerce Clause: that Notice 90-3 discriminates against corporations who affiliate with non-California taxpayers. As discussed above, this is not correct.

Under the theories of combined reporting, the FTB properly considered the sales of Deluxe's affiliates in determining the portion of the unitary group's income attributable to California sources. The relevant tax, levied on Deluxe, is rationally related to the unitary business principles which treat the business operations of all unitary group members as contributors in income generated in California. Accordingly, there is no Equal Protection violation.

IV. *Appeal of Huffy* (1999) 96R-1263

Deluxe requests that the statement of decision be enlarged to address the recent decision by the State Board of Equalization in the *Appeal of Huffy Corporation* (1999) 96R-1263. A decision of the State Board of Equalization, as an administrative agency of the state, is persuasive but not binding on this court. "While an interpretation put forth by an administrative agency charged with enforcement, implementation and interpretation of enactments is

entitled to great weight, a court may properly accept or reject it according to the validity of its reasoning, its consistency, and all those factors which give it power to persuade, if lacking power to control." (*Rain Bird Sprinkler Mfg. Corp v. Franchise Tax Bd.* (1991) 229 Cal.App.3d 784, 791-792, internal citations omitted.)

In *Huffy*, the Board rejected the *Finnigan* apportionment rule and adopted prospectively the rule from *Joyce*. The primary reason for doing so was that, contrary to the Board's prior expectations, the vast majority of other taxing jurisdictions did not adopt the *Finnigan* rule. (*Appeal of Huffy Corporation*, 96R-1263, p. 5.) "Although there was the hope that with the adoption of the *Finnigan/NutraSweet* line of cases, the new apportionment rule would lead to a more theoretically sound application of the unitary method, there has been academic criticism of the actual result. . . . While there were theoretically good reasons for the initial implementation of the *Finnigan/NutraSweet* rule, the actual practice has resulted in taxation of income which would not otherwise be taxed by the State of California." (*Id.* at 5-6.) In an effort to promote uniformity in the application of the UDITPA, the Board decided to revert to the pre-*Finnigan* method of apportionment. (*Id.* at 6.) This decision, however, is to apply only prospectively, to income years beginning on or after April 22, 1999, the date of the *Huffy* decision. (*Id.* at 8.)

Deluxe reads *Huffy* as further support for its contention that the *Finnigan* rule indirectly taxes income in violation of Public Law 86-272. That, however, is not the holding in *Huffy*. The decision in *Huffy* is based on the practical application of two methods of apportionment

and the desirability of consistency between the various taxing jurisdictions. The Board did not alter its position because it determined that the *Finnigan* rule is contrary to the federal statute or constitutional principles. Indeed, the fact that the Board made its decision apply only prospectively reinforces the conclusion that changes in the state's method of taxing unitary groups are permissible and do not invalidate the method used in prior years.

CONCLUSION

For the reasons set forth above, the reasoning in the *Finnigan* decisions is sound and the apportionment methodology in Notice 90-3 is fairly calculated to assign to California that portion of the net income reasonably attributable to the business done here. This conclusion remains true even if the FTB reverts to the *Joyce* approach in subsequent years. Deluxe therefore is not entitled to any refund in the taxes it has paid, and judgment should be entered for the defendant.

Counsel for defendant should prepare and submit a judgment approved as to form by counsel for plaintiff.

Dated: 5/26/99

/s/ Stuart R. Pollak
Stuart R. Pollak
Judge of the Superior Court

Superior Court of California
City and County of San Francisco

DELUXE CORPORATION, a Minnesota Corporation, Plaintiff(s) vs. FRANCHISE TAX BOARD, an agency of the State of California, Defendant(s)	Case Number: 991237 **CERTIFICATE OF MAILING** (CCP 1013a (4))

I, Andrea Carney, a Deputy Clerk of the Superior Court of the City and County of San Francisco, certify that I am not a party to the within action.

On May 26, 1999 I served the attached Statement of Decisions by placing a copy thereof in a sealed envelope, addressed as follows:

Charles J. Moll III
Edwin P. Antolin
Morrison and Foerster
425 Market Street
San Francisco, California
94105-2482

Bill Lockyer, Attorney General
Joyce E. Hee, Deputy Attorney General
Attorney General's Office
1515 Clay Street,
21st Floor
Oakland, California
94612-1413

and, I then placed the sealed envelopes in the outgoing mail at 400 McAllister Street, San Francisco, CA. 94102 on the date indicated above for collection, attachment of

required prepaid postage, and mailing on that date following standard court practices.

Dated: May 26, 1999

ALAN CARLSON, Clerk

By: /s/ Andrea Carney
Andrea Carney, Deputy Clerk

APPENDIX C

Court of Appeal, First Appellate District,
Division Two – No. A088142
S098102

IN THE SUPREME COURT OF CALIFORNIA

En Banc

DELUXE CORPORATION, Plaintiff and Appellant,

v.

FRANCHISE TAX BOARD, Defendant and Respondent.

(Filed Jul 11, 2001)

Petition for review DENIED.

Werdegar J., was absent and did not participate.

GEORGE
Chief Justice

APPENDIX D

Public Law No. 86-272

15 USCS § 381 (2001)

§ 381. Imposition of net income tax

(a) Minimum standards. No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after the date of the enactment of this Act [enacted Sept. 14, 1959], a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

(1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and

(2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

(b) Domestic corporations; persons domiciled in or residents of a State. The provisions of subsection (a) shall not apply to the imposition of a net income tax by any State, or political subdivision thereof, with respect to –

(1) any corporation which is incorporated under the laws of such State; or

(2) any individual who, under the laws of such State, is domiciled in, or a resident of, such State.

(c) Sales or solicitation of orders for sales by independent contractors. For purposes of subsection (a), a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, of tangible person property.

(d) Definitions. For purposes of this section –

(1) the term "independent contractor" means a commission agent, broker, or other independent contractor who is engaged in selling, or soliciting orders for the sale of, tangible personal property for more than one principal and who holds himself out as such in the regular course of his business activities; and

(2) the term "representative" does not include an independent contractor.

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15 USCS § 382 (2001)

§ 382. Assessment of net income taxes

(a) Limitations. No State, or political subdivision thereof, shall have power to assess, after the date of the

enactment of this Act [enacted Sept. 14, 1959], any net income tax which was imposed by such State or political subdivision, as the case may be, for any taxable year ending on or before such date, on the income derived within such State by any person from interstate commerce, if the imposition of such tax for a taxable year ending after such date is prohibited by section 101 [15 USCS § 381].

(b) Collections. The provisions of subsection (a) shall not be construed –

(1) to invalidate the collection, on or before the date of the enactment of this Act [enacted Sept. 14, 1959], of any net income tax imposed for a taxable year ending on or before such date, or

(2) to prohibit the collection, after the date of the enactment of this Act [enacted Sept. 14, 1959], of any net income tax which was assessed on or before such date for a taxable year ending on or before such date.

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15 USCS § 383 (2001)

§ 383. "Net income tax" defined

For purposes of this title [15 USCS §§ 381 et seq.], the term "net income tax" means any tax imposed on, or measured by, net income.

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15 USCS § 384 (2001)

§ 384. Separability

If any provision of this title [15 USCS §§ 381 et seq.] or the application of such provision to any person or circumstance is held invalid, the remainder of this title [15 USCS §§ 381 et seq.] or the application of such provision to persons or circumstances other than those to which it is held invalid, shall not be affected thereby.

APPENDIX E

STATE OF CALIFORNIA
FRANCHISE TAX BOARD
Mailing address:
Legal Division
P.O. Box 1468
Sacramento, CA 95812-1468
(916) 369-3337

June 8, 1990
FTB NOTICE 90-3
410:BRL:CN-90-363

Re: Sales Factor Throwback; Revenue and Taxation Code §25135

In the Appeal of Finnigan Corporation, 88-SBE-022, August 25, 1988, the State Board of Equalization (SBE) specifically ruled that the word "taxpayer" as used in Revenue & Taxation Code Section 25135(b)(2) means "all of the corporations within the unitary group." Therefore, the SBE held that when sales were shipped from California to another state by a member of a group conducting a unitary business in California, the throwback rule does not apply if any of the corporations within the unitary group is taxable in the other state. In the Appeal of Finnigan Corporation, Opn. on Pet. for Rehg., 88-SBE-022A, January 24, 1990, the SBE expressly overruled the apportionment rule announced in the Appeal of Joyce, Inc., Cal. St. Bd. of Equal., November 23, 1966, that the income attributable to the California activities of a corporation exempt from taxation by this state because of Public Law 86-272 had to be separately computed by application of the apportionment method and then

excluded from the measure of the franchise tax. In practice, the Joyce rule was accomplished by excluding from the numerator of the apportionment formula, but not the denominator, the California factors of corporations within the unitary group that were not themselves taxable by this state. Under Finnigan, this restriction no longer applies.

Accordingly, the Franchise Tax Board's administrative practice with respect to multi-entity apportionment formula rules previously governed by Joyce has now changed as follows:

1. Sales of goods shipped from California to other states are to be assigned to this state under the throwback rule only when none of the corporations within the unitary group is taxable within the destination state.

2. The California property, payroll and sales of each corporation within a unitary group will be taken into account in the apportionment of business income to this state, including amounts attributable to entities exempt from taxation in this state because of Public Law 86-272. The total business income thus apportioned to California will be assigned to the individual corporations taxable by this state by use of the "revised method" currently authorized by Legal Ruling 234, as modified in the following example.

EXAMPLE

Corporations A, B, and C are engaged in a unitary business.
Corporations A and C are taxable by California, but Corporation B is exempt from taxation in California under Public Law 86-272.

The basic computations necessary to determine the amounts of business income from California sources attributable to Corporations A and C are as follows:

COMBINED APPORTIONABLE BUSINESS INCOME $1,000,000

APPORTIONMENT FACTORS:

	TOTAL EVERYWHERE	WITHIN CALIFORNIA			
		CORP A	CORP B	CORP C	TOTAL CA
PROPERTY	$ 600,000	$ 24,000	$ 0	$ 36,000	$ 60,000
PAYROLL	400,000	14,000	0	26,000	40,000
SALES	5,000,000	150,000	450,000	400,000	1,000,000

COMBINED CALIFORNIA APPORTIONMENT FORMULA:

PROPERTY PERCENTAGE	4.00%	0.00%	6.00%	10.00%
PAYROLL PERCENTAGE	3.50%	0.00%	6.50%	10.00%
SALES PERCENTAGE	3.00%	9.00%	8.00%	20.00%
TOTAL				40.00%
AVERAGE				13.33%

BUSINESS INCOME APPORTIONED TO CALIFORNIA: $ 133,333

LR 234 "REVISED METHOD" – RELATIVE FORMULA PERCENTAGE CALCULATION

	CORP A	CORP B	CORP C	TOTAL CA
PROPERTY FACTOR %	4.00%	N/A	6.00%	10.00%
PAYROLL FACTOR %	3.50%	N/A	6.50%	10.00%
SALES FACTOR %	3.00%	N/A	8.00%	11.00%
TOTAL PERCENT	10.50%	N/A	20.50%	31.00%
AVERAGE PERCENT	3.50%	N/A	6.83%	10.33%
RELATIVE PERCENT	33.87%	0.00%	66.13%	100.00%
BUSINESS INCOME APPORTIONED TO EACH CALIFORNIA TAXPAYER	$45,161	$0	$88,172	$133,333

DRAFTING INFORMATION

The principal author of this notice is Bruce R. Langston, Senior Staff Counsel, Franchise Tax Board Legal Division. For further information regarding this notice, contact Mr. Langston at P.O. Box 1468, Sacramento CA, 95812-1468.

bcc: Information Files: Apportionment-UDITPA-Sales Factor

APPENDIX F

[LOGO]

CALIFORNIA FRANCHISE TAX BOARD
Legal Ruling No. 234 **October 27, 1959**

ALLOCATION: APPORTIONMENT OF THE CALIFORNIA INCOME OF A UNITARY BUSINESS.

> The California income of a unitary business must be divided among corporations having activities in this state, by assigning it to each corporation in accordance with the average ratio that the California factors of each such corporation bear to the total factors of the group.

The relative factor method of separating the income of a unitary business between the corporations, having activities in this state, approved by the State Board of Equalization in the Appeal of Kaiser-Frazer Sales Corporation, November 7, 1958, is revised as illustrated below.

Assume that the unitary income of a group of corporations is $1,000,000 and it does 13-1/3% of its business in California. The total factors and California factors of each member are as follows:

Denominators

	A	B	C	Total
Property	500,000	64,000	36,000	600,000
Payroll	300,000	74,000	26,000	400,000
Sales	4,000,000	600,000	400,000	5,000,000

Numerators

	A	B	C	Total
Property	24,000	-	36,000	60,000
Payroll	14,000	-	26,000	40,000
Sales	150,000	450,000	400,000	1,000,000

Under the new method of computation, this result would follow:

	A	B	C	Total
Property	4%	-	6%	10%
Payroll	3.5	-	6.5	10%
Sales	3.0	9	8	20%
Total	10.5%	9%	[20.5%]	40%
Average	3.5%	3%	[6.83$^1/_3$%]	13$^1/_3$%

Applied to income of $133,333.

A	- 3.5%	×	$1,000,000	=	35,000
B	- 3%	×	$1,000,000	=	30,000
C	- 6.83$^1/_3$%	×	$1,000,000	=	68,333
					$133,333

This method appears to produce a more accurate result than the relative factor method. If two or more corporations contribute to the earnings of the California income, the relative contributions of each [are] measured by the relationship of their California factors to the total factors of the group, rather than the ratio that the California factors bear to each other.